DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS: 02-0014
Indiana Sales and Use Tax
For the Tax Years 1996 Through 2000

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Integrated Production Process – Sales and Use Tax.

Authority: IC 6-2.5-1-1 et seq.; IC 6-2.5-5-3; IC 6-2.5-5-3(b); Rotation Products Corp. v. Dept. of State Revenue, 690 N.E.2d 795 (Ind. Tax Ct. 1998); Harlan Sprague Dawley, Inc. v. Dept. of State Revenue, 605 N.E.2d 1222 (Ind. Tax Ct. 1992); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); Indiana Dept. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983).

Taxpayer maintains that its "integrated production process" begins at the point where it first obtains waste oil from its suppliers and ends at the point where the fully processed oil is delivered to its customers.

II. Sales and Use Tax Refund Claim.

Authority: IC 6-8.1-9-1(a).

Taxpayer argues that it was entitled to submit a claim for refund of sales and use taxes paid by a predecessor company.

III. Abatement of the Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1(a); IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(c).

Taxpayer repeats its assertion that the audit's assessment of the ten-percent negligence penalty was unwarranted and that it is entitled to relief from that penalty.

STATEMENT OF FACTS

Taxpayer is in the business of acquiring, processing, and reselling petroleum products. Taxpayer purchases waste oil from various suppliers and – in some circumstances – is paid by suppliers who wish to dispose of their waste oil.

Taxpayer treats the waste oil at three distinct stages. When taxpayer first picks up the oil, it is filtered as it is being pumped into one of the taxpayer's trucks in order to remove certain contaminants. Thereafter, this partially filtered oil is transferred to taxpayer's central processing facility. At this facility, the waste oil undergoes additional filtration. In addition – during the period of time considered by the audit – taxpayer employed two supplementary methods of treating the oil at the central facility. Depending upon the nature of the contaminants contained within the waste oil, taxpayer used either a heat treating process or a chemical process. After treatment at the central facility, the oil is transported to one of the taxpayer's customers. As the partially treated oil is off-loaded, the oil is once again filtered.

Taxpayer's customers are uniquely equipped to burn this fully treated oil. Those customers include asphalt companies, steel mills, papers mills, and electric utilities. Unless the waste oil was properly treated to remove the offending contaminants, these customers would be unable to use the waste oil as fuel.

Taxpayer is also engaged in the business of cleaning up, treating, and appropriately disposing of contaminated water and contaminated solids.

The audit found that taxpayer's field-filtering activities, which occurred before the oil reached the central processing facility, were "preproduction" activities. The audit found that taxpayer's field-filtering activities, which occurred after the treated oil left that same facility, were "post-production" activities. In both instances, the audit determined that taxpayer's equipment employed during these "preproduction" and "post-production" activities was not entitled to an exemption from the state's gross retail tax. Therefore, the audit concluded that taxpayer's field-filtering equipment was not entitled to the exemption.

The taxpayer disagreed with the audit's conclusion. In effect, taxpayer argued that processing of the waste oil – from the point at which the waste oil was first acquired to the point where the processed oil was delivered to one of its customers – constituted one, unbroken production process.

At least in part, the original Letter of Findings (LOF) agreed with taxpayer's argument. The LOF agreed that taxpayer's "field-filtering" activity altered the nature and composition of the oil both at the time the waste oil was pumped on-board taxpayer's truck and at the point where the fully-processed oil was off-loaded at the customers' location. Therefore, the LOF concluded that the taxpayer was entitled to purchase the field-filtering equipment without paying sales tax. However, the Department explicitly disagreed with taxpayer's implication that its exempt activities activity extended in one unbroken, indivisible process from the point at which it first acquired the waste oil to the point where it made the final delivery of the processed oil. The Department concluded that taxpayer was entitled to an exemption for the field-filtering equipment. However, it was not entitled to an exemption on the trucks used to transport the oil to the central facility, and it was not entitled to an exemption on the trucks used to deliver the treated oil to the customers.

Thereafter, taxpayer requested that the Department revisit the issue. An opportunity was provided for taxpayer to explain its position during an administrative hearing, and this Supplemental Letter of Findings follows.

DISCUSSION

I. Integrated Production Process – Sales and Use Tax.

Indiana imposes a sales tax on retail transactions and a complimentary use tax on tangible personal property that is stored, used, or consumed in the state. IC 6-2.5-1-1 et seq. In its original protest, taxpayer argued that it was entitled to a sales tax exemption on the field-filtering equipment installed on its trucks pursuant to IC 6-2.5-5-3(b). That exemption statute reads as follows:

> Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for *direct* use in the *direct* production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. (*Emphasis added*).

Taxpayer filters the waste oil at the time the waste oil is first acquired from the supplier; in order to remove coarse contaminants, the oil is filtered at the point the oil is pumped on-board the taxpayer's truck. The oil is then transported to taxpayer's central location where further processing – including additional filtration – occurs. After the processing at the central location is complete, taxpayer transports the oil to the customer's site. As taxpayer pumps the oil out of its delivery truck, the oil is once again filtered in order to assure that the oil may be used by the customer.

The original LOF determined that taxpayer was entitled to a sales tax exemption for the field-filtering equipment because the equipment was one step in the process whereby taxpayer changed the "form, composition, and character of the waste oil" producing a marketable product.

However, taxpayer argues that – having determined the field-filtering equipment was exempt – the trucks upon which this equipment is installed are also entitled to the same exemption.

To that end taxpayer cites to General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991) *aff'd* 599 N.E.2d 588 (Ind. 1992).

In General Motors, the automobile manufacturer shipped component automobile parts to its plants and claimed an exemption for the purchase of items employed in the interdivisional transfer of those components parts. The court held that the automobile manufacturer's packing materials were part of the integral process whereby the manufacturer produced its finished product. Therefore, the automobile manufacturer's packing materials were exempt under IC 6-2.5-5-3. The court reached that decision after finding the automobile manufacturer's widely separated production facilities formed a cohesive, singular production unit in which the claimant's "manufacture of finished marketable automobiles [was] accomplished by one continuous integrated production process within which the transport of parts from component plants to assembly plants [was] an essential and integral part." General Motors, 578 N.E.2d at 404.

In finding that the automobile manufacturer's production process encompassed manufacturing activities performed at multiple sites, the court identified a number of significant facts. Specifically, the court found that "[t]he facts in the case [FN3] as well as previous judicial findings [FN4] indicate GM's production process is by nature highly integrated. The court's sole concern, however, is whether GM's manufacturer of finished automobiles qualifies as one continuous integrated production process for the purpose of exemption from sales/use tax." Id. at 402.

Footnote three gives some indication of the evidence which the court relied in arriving at a conclusion that GM's production was both "continuous" and "integrated." Specifically, the court found that "GM's component plant personnel collaborate with the assembly plant personnel (1) to develop new product concepts, (2) to individually design, engineer, and test the performance of new parts and packing materials, (3) to plan the layout and production processes for new parts, (4) to coordinate production schedules because delays at one plant would have an immediate effect on the other plants, and (5) to solve problems and ensure quality control." Id. at n.3. In addition, the court noted that a "continuity of production exists between GM's different plants [which is] demonstrated by the standard practice of shifting certain production operations back and forth between component and assembly plants when necessary for more efficient operation." Id.

It was in the context of these particularized facts and findings that the court held that GM's manufacture of automobiles represented one "continuous integrated production process." Id. at 404. It was in the context of these particularized facts and findings that the court held that GM's assembled automobiles, and not the automobile's component parts, constituted the taxpayer's most marketable product and that the production of the that "most marketable product" constituted the conclusion of GM's integrated but physically discontinuous manufacturing process.

In addition, taxpayer cites to Indiana Dept. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983) to support its contention that its trucks are exempt from sales tax. In that case, the court found that appellee taxpayer's trucks – used to transport unfinished stone from one stage of production to another – were exempt from sales tax because the equipment was being used within that taxpayer's own on-site production process whereby it manufactured crushed stone. Cave Stone 457 N.E.2d at 521, 523.

Nonetheless, the Department must disagree with the taxpayer's contention that its trucks are exempt from sales tax because the trucks are not used to move the waste oil and the semi-processed oil *within* an integrated, continuous, indivisible, product whereby taxpayer transforms the waste oil into usable, fully processed oil.

Unlike the automobile manufacturer in General Motors, there is no indication that the initial filtering, which occurs at the time the waste oil is first loaded on-board its trucks, is inextricably linked to the processing activities which take place at taxpayer's central location. In addition, there is no indication that the filtering which occurs at the point where the semi-processed oil is off-loaded is in anyway integrated with the processing activities which occur back at the central processing facility. Instead, the fact that taxpayer has chosen to conduct certain of its filtering activities off-site – whether by happenstance, necessity, or design – does not serve to bring each and every item of equipment within the "integrated" process whereby taxpayer produces usable, processed oil.

The Department is aware of the requirement that the legislature's intent in creating the exemption must not be so narrowly defined as to preclude from exemption those items which properly belong with the ambit of the exemption. Harlan Sprague Dawley, Inc. v. Dept. of State Revenue, 605 N.E.2d 1222, 1225 (Ind. Tax Ct. 1992). However, "it is [also] well-settled that exemptions are strictly construed against the taxpayer." Rotation Products Corp. v. Dept. of State Revenue, 690 N.E.2d 795, 798 (Ind. Tax Ct. 1998).

Taxpayer is entitled to the exemption for the field-filtering equipment which acts directly upon the waste oil and the semi-processed oil. Nonetheless, the Department must give effect to the requirement that, in order to qualify for an exemption pursuant to IC 6-2.5-5-3(b), the equipment must be one of the constituent elements within "an integrated process which produces tangible personal property," Rotation Product, 690 N.E.2d at 799, and must be "an essential and integral part of an integrated production process." General Motors, 578 N.E.2d at 401. Unlike appellee taxpayer's trucks in Cave Stone, taxpayer's own trucks are not "an essential and integral part of the procedures by which the [product] is transformed into a marketable product." Cave Stone, 457 N.E.2d at 523. Taxpayer's field-filtering activities are not an indivisible, component of the taxpayer's production process because the field-filtering activities and the processing which occurs at the central location to do not together form "one continuous integrated process." General Motors, 578 N.E.2d at 402. The Department is unable to accept taxpayer's expansive construction of the exemption statute and the relevant case law.

FINDING

Taxpayer's protest is respectfully denied.

II. Sales and Use Tax Refund Claim.

At the time the original audit report was prepared, taxpayer submitted a request for refund of 1996-1999 sales and use taxes purportedly paid in error. The audit concluded – in part – that the taxpayer was not entitled to make the claim because "it had filed claim for payment of tax on purchases made by another entity and prior to the creation of taxpayer corporation." The original LOF agreed and denied the taxpayer's protest of this issue.

The relevant statute provides that, “If a person has paid more tax than the person determines is legally due for a particular taxable period, the person may file a claim for refund with the department.” IC 6-8.1-9-1(a). Because taxpayer was incorporated in August of 1997, taxpayer’s request for refund of taxes paid in 1996 and 1997 was denied because taxpayer had initially failed to demonstrate that it was the same “person” as the predecessor company which had originally paid the taxes. As stated in the original LOF, “the only thing which is certain is that taxpayer sprang into existence on August 4, 1997, and that taxpayer and the predecessor share similar names.”

Pursuant to its request that the Department reconsider this issue within the Supplemental Letter of Findings, taxpayer has provided information documenting taxpayer’s acquisition of predecessor company’s assets. In a “Written Action of the Company Managers,” predecessor company was directed to “transfer all of its assets, real and personal, tangible and intangible, to [taxpayer].” In a copy of the “Bill of Sale,” predecessor company agreed to sell all of its “assets, tangible, and intangible, of whatever kind and nature” to taxpayer. In that Bill of Sale, predecessor company promised that it was the owner of the transferred property, that the property was free of any undisclosed encumbrances, and that the predecessor company would protect taxpayer’s interest in the property if any future claims were made against that property. An examination of the Secretary of State’s records indicates that predecessor company survived the sale of the assets and did not become inactive until September 2000 approximately three years after predecessor company sold taxpayer its assets.

Taxpayer has not established that it is the same “person” as predecessor company. Under IC 6-8.1-9-1(a), it is not entitled to submit a claim for refund of taxes paid by predecessor company because taxpayer is a different “person” than predecessor company. The documentation reveals that taxpayer entered into an asset sale with predecessor company; taxpayer did not merge with or subsume predecessor company evidenced by the fact that predecessor company maintained a separate business existence until three years after the date of the asset sale. In addition, the parties’ own agreement indicates that taxpayer expected predecessor company would survive the asset sale in order to defend taxpayer against any future challenge to taxpayer’s ownership rights to the transferred assets. Predecessor company was entitled to submit a claim for a refund of taxes. There is no indication taxpayer, by purchasing the assets of predecessor company, succeeded to that entitlement.

FINDING

Taxpayer’s protest is respectfully denied.

III. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer repeats its assertion that it is entitled to abatement of the ten-percent negligence penalty imposed pursuant to IC 6-8.1-10-2.1(a).

Under IC 6-8.1-10-2.1(d) the Department is authorized to waive the penalty if the taxpayer demonstrates that its failure to pay the tax deficiency was based on "reasonable cause and not due to willful neglect." 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . ."

In the original LOF, the department declined to abate the penalty concluding that taxpayer's "bare assertion that it 'demonstrated reasonable cause for the Department to waive the negligence penalty' [was] insufficient to establish that it exercised the 'ordinary business care and prudence' required of an 'ordinary reasonable taxpayer.'" Taxpayer has presented nothing which would permit the Department to depart from that original conclusion.

FINDING

Taxpayer's protest is respectfully denied.

DK/JM/MR – 031206